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## Effects of Stabilization Measures on Economic Growth

By

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The Committee for Economic Development\*

What governmental policies can we adopt that will promote economic stability but that will not interfere unduly with economic growth? This is not a new problem, for the people of this country have been interested in both economic growth and in economic stability from the very beginning. But although it may not be a new problem, it has an urgency today that it never has had before. This urgency comes from the fact that it is only in recent years that we have come to understand—or to think we understand—the operation of our economic system sufficiently to attain a high level of economic stability.

Instability of output and employment have always produced discontent and discomfort just as they would and do now. The change that has taken place is in our attitude toward instability. We now urge our government to take measures that will reduce instability and we give our approval to a wide range of devices directed to this end. Partly because we are now more confident that unemployment can be successfully combated, but also because the suffering of the 1930's is still remembered by many of us, we have become less tolerant of unemployment. It is very doubtful that the rates of unemployment that were experienced in the 1930's would now be accompanied by the levels of apathy and acceptance that marked the early years of the Great Depression.

There are many other changes relevant to our problem besides the change in attitude toward instability and the possibility of reducing it. The 1930's brought fundamental changes in banking legislation, of which deposit insurance was a part, that greatly decreased the likelihood that the banking system will accentuate contraction of output as it often has done in the past. In addition, both government expenditures and taxes are now a higher

percentage of national income. In some respects, this change eases the task of maintaining stability, but at the same time it carries with it the possibility of affecting the climate for enterprise adversely.

At the same time that our desire and ability to reduce instability have increased, we have become more and more aware of the necessity for maintaining a rapid rate of economic growth. A rapid rate of economic growth has always been desirable if only to provide our citizens with more goods and services to consume, including leisure. But in recent years the problem of national security has made it more urgent to maintain a rapid pace of technological advance and a rapid rate of economic growth. Hence it is important to ask whether attempts to reduce instability may have an adverse reaction on the rate of economic growth. Is it possible to press so hard for greater economic stability that the rate of economic growth will be slowed down?

The problem of finding the desirable compromise between growth and stability is very much like the problem facing the man who wants to drive his automobile through traffic both safely and fast. If he drives recklessly, he may get to his destination very slowly—perhaps only after a stay in the hospital. If he behaves with more stability and drives in a safer manner, he will actually reduce the length of time it takes to reach his destination. But it is possible for him to be so careful as to increase the length of time it takes to reach his destination. In fact, the way to be completely safe is never to make the trip at all, but in this case the driver does not reach his destination. Thus the person driving his automobile in traffic always makes a choice, or a compromise, between speed and safety. Within the practical range of choice, the faster he tries to go the less safe will he be. And the safer he tries to be, the more time it will take him to make the trip.

\*The Committee for Economic Development is a non-profit organization of businessmen and educators who contribute their time and experience to economic research and education.

Similarly, within the practical range of choice a rapid rate of economic growth probably requires a considerable amount of instability. And if we try to attain too high a degree of stability, economic growth may be slowed down, just as the automobile driver is slowed down if he tries to attain too high a degree of safety.

Although it might be desirable from the point of view of symmetry to discuss the mutual relations of policies directed toward growth and stability, this discussion will be confined to the effects of stabilization policy on economic growth. The reason for casting the discussion in this form is that the scope for altering growth policy in the short run is very slight. In the short run, the thing that gets adjusted is stabilization policy. Many governmental policies that have important affects on growth may have little if any discernible impact on stability. Accordingly the problem is here viewed as one of attaining a satisfactory level of stabilization in such a way as not to hinder economic growth.

#### Definitions

Conclusions about the problem of attaining both stability and growth will depend on what aspects of stability and growth are regarded as particularly significant. The nature of the possible conflict between growth and stability cannot be examined very closely unless we are clear on what it is that is supposed to grow and what is supposed to be stable.

In the ordinary course of events the total real output of the economy (for example, gross national product valued at constant prices) would be expected to grow. But it is rather generally agreed that a better measure of growth would be real output per man-hour used in production. This measure of growth would register an increase, for example, if total measured output remains the same but hours worked each week decline from, say, 40 to 30.

It is harder to say what it is we want to stabilize. We do not want a constant real output. We do not want a constant money output, for that would imply satisfaction with a halving of real output if prices were to double. Nor do we insist on a constant rate of growth in any of the quantities that have been discussed. In aggregative terms, however, we do want a reasonable stability in the growth of real output and, at the same time, in the level of employment. But I believe that most people are concerned about fluctuations in total real output because these ups and downs are often associated with instability in the real consumption of particular families. That is, if total output grew rapidly over the long run but fluctuated from year to year, we would not be much concerned if the real consumption of families were not affected. This distinction between fluctuations in output and in family consumption is of considerable importance, for instability in the real consumption of particular families is not necessarily associated with instabili-

ty in over-all output or the output of particular industries. Many people would regard "stability" as satisfactory if the real consumption of individual families is not interrupted by long periods of unemployment with the wage earner able and willing to work.

#### Instability and Growth

Although economic growth necessitates some instability, growth can be hindered by instability that comes from sources that have no necessary connection with growth. Instability from these sources can therefore be reduced with no adverse effects on growth. But the further reduction of economic instability can be carried to the point where it infringes on fundamental conditions that are necessary for the process of growth to take place.

What are some of the preconditions for growth that may be affected by attempts to reduce instability? The conditions set down here are not a complete list of those required for growth and would not guarantee growth. They would probably play an important part in a theory of growth, but the mere listing of these conditions does not constitute such a theory. They are even far from being a complete list of the prior conditions lying behind the economic growth that has taken place in this particular country. But they do represent condi-

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tions that are both (a) widely thought to be necessary for economic growth in our economy and (b) likely to be affected by proposals to reduce instability.

The first condition for economic growth is that the economy be operating at a high level of **efficiency**. Are labor and services of capital goods producing as much real output as possible? A high level of output is likely to be associated with more rapid growth because a high level of output permits a higher level of investment. If growth is to be promoted by efficient production, the economy needs the change, the fluidity, and the adaptiveness that result from vigorous competition. And the number of sellers in an industry is an important determinant of the vigor of competition. If the number is too few, it is unlikely that the customer will get the benefit of prices that have been lowered to attract more business. The result may be effective agreement to maintain prices rather than compete or at least reluctance to try to get more business by lowering price.

If there is vigorous competition, a product enjoying a price that yields an unreasonably high rate of return on investment should quickly experience the competition of new firms. Effective competition will bring the rapid adoption of new and cheaper methods of production by most of the firms in an industry, because a firm cannot survive if it keeps on using more expensive methods of production. In short, efficient operation of the economy will be stimulated if (1) there is a widespread and intensive effort to find and exploit profit opportunities, and (2) the barriers to entering profitable fields are not so high that it is very difficult to overcome them.

The second condition for economic growth is a **favorable climate for investment**. The economic system would not function well if profits were always so quickly eliminated—whether by competition, taxes, or in other ways—that they never materialize. There must be the possibility of handsome rewards for ingenuity in discovering cheaper methods of production and for the conception and development of new products that are better adapted to satisfying consumer wants than were the old. Not only must there be a possibility of generous reward, but it is probably necessary that this possibility actually be realized in a substantial number of cases if the inducement is to be effective. The inducement must be available not only to the innovator, but also—perhaps in smaller degree—to the producer who applies already existing knowledge to his own production problems in an effective way.

**Price level stability** is a third important condition for growth that may be affected by efforts to decrease instability. Efficiency in production (and consumption) requires comparison of the prospective gain (or satisfaction) with the cost of pro-

ducing a product (or satisfying a want) in a certain way. If this comparison is to be made, the producer or the consumer must know the relative prices of the different kinds of labor, materials, and the other goods and services involved. If his decisions are based on erroneous estimates of the relative scarcity of the different factors of production, he may find himself using expensive labor, for example, on tasks where it is not productive enough to cover its high cost. A changing price level will alter these relative prices in ways that have nothing to do with the fundamental scarcities of the products and services. Consequently it is difficult to know on what relative prices plans for production should be based. The result is that the efficiency with which current production is carried on will suffer.

The effect on investment decisions, which require careful estimates looking far into the future, is still more serious. When the price level is changing, the prices experienced during this change are unlikely to reflect long run relative values. The result will be an increase in the amount of investment that turns out not to have been warranted.

#### **Stabilization Policies and Their Effect On Growth**

The number of stabilization policies open to us is very large, but from one point of view they fall into two general classes. The first class consists of those policies that are directed to the stabilization of particular industries; the second class of policies is directed to the stabilization of economic activity in general rather than the stabilization of particular industries.

In appraising stabilization policies, we must remember that so long as we have any economic growth at all, there will inevitably be some instability and unemployment. Economic growth means the introduction of new ways of doing things and the introduction of new products that compete with old products. Growth means not only new machines, but changes in the way businesses are organized and changes in methods of distribution. The inevitable result has been and will be declines in the demand for **some** products, declines in the demand for **some** types of labor, and declines in the over-all level of economic activity in **some** localities or even regions.

Changes of these types clearly involve shifts in the pattern of investment, but there will be more than just a changing pattern of investment. With the total volume of investment dependent on the decisions of private businessmen and with investment and other necessary economic changes working out their effects only over the passage of time, it is hard to believe that the system could function without some fluctuations in the total volume of investment, consumption, and employment.

Granted that growth necessitates some degree of instability, it would be a mistake to accept every degree of instability as a necessary result of growth,



Within limits, instability can be reduced without adversely effecting growth, and some ways of reducing instability will have a less adverse effect on growth than other ways. The problem is how far to go in trying to reduce instability and how to set about doing this.

### **The Easy Cases of Instability**

The problem of adjustment is comparatively simple if moderately increased unemployment is associated with products that do not dominate particular areas of the country and there are not too many of these cases. If the shifts in demand are permanent, outputs of other products and methods of production can be and are adjusted to the new situation. Labor will move to other jobs and depreciation funds will be invested in other industries rather than being used to replace worn-out capital goods in the declining industry.

When there is a reduction in the output of an industry (or industries) that dominate an area, however, adjustment is considerably more difficult. If the unemployed workers are to find new jobs, more of them will have to go to other areas, but distance makes it more difficult for labor to move. It is in these cases that government begins to receive pressure to "do something" about it. And these situations, if very many areas and industries are affected, shade into cases of widespread and general unemployment.

### **Stabilization of Particular Industries**

Because unemployment and declines in output always involve particular industries it is easily understandable that the cry to "do something" is often a cry to "stabilize" or relieve the particular industry involved.

For example, if the product has competition from imports, why not raise the tariff in order to relieve the industry? If prices and profits have been declining, why not organize to protect the members of the industry from cut-throat competition? Why not set minimum prices? Why not require a showing that additional capacity is really needed before it can be erected? Or perhaps the remedy is thought to lie in having the government purchase the product of the ailing industry or favor the area in its purchasing program.

"Stabilization" of the sick industry often has a wide popular appeal. It may seem obvious that a direct method of relieving the disagreeable symptoms of unemployment and losses is to be preferred to an indirect method. But there is more to the problem than merely relieving symptoms. What are the effects of such measures on other industries and on the economy at large? What happens if remedies of this sort are widely applied? Are there better remedies?

Our government has often experimented with remedies directed to the "stabilization" of an ailing industry. The 1930's provided us with many ex-

amples, including the NRA, the farm product price support programs, bituminous coal, motor trucking, and so on. Some of these are still with us. Recent minor examples have been provided by actions taken under the escape clause of the trade agreements program.

The merits of these particular programs cannot be assessed here, but it would be hard to emphasize too strongly the dangers that accompany attempts to "stabilize" particular industries whose output and employment have declined. If the decline in demand for the industry's output turns out to be permanent rather than temporary, the "stabilization" remedy will have slowed down and impeded needed transfers of resources to other industries and perhaps other areas. It will have diminished the fluidity in the economy that is so necessary for growth to take place.

On the other hand, if the decline in the industry's output turns out to be temporary, there is a substantial body of experience to warrant the conclusion that it is very difficult to get rid of "stabilization" devices once the industry has come to depend on them. They often restrict freedom of entry, and a protected opportunity is created for inefficiency or excessive profits or both. Conditions of this sort cannot help but be a deterrent to growth. The scope for enterprise is reduced and the stimuli to efficiency and innovation are weakened. It should also be noted that the policies mentioned, with the exceptions of increased tariff and government purchase programs, do not relieve the unemployment associated with the decline in the industry's output.

A decline in the output of a particular industry would be better dealt with by policies that encourage and facilitate the movement of labor and capital to other industries. Consistent with this objective are simple and straightforward actions to disseminate information on what is happening. Businesses in other areas should be informed of the facilities and labor supply that are available. The program for adjustment should include provision of competent vocational advice to the young, possibly retraining of workers, and certainly a well functioning system of employment exchanges. In addition there are many laws whose formulation and administration can affect the ease with which both capital and people can move. The unemployment insurance and relief laws and regulations are particularly important, as are also the conditions under which private pensions are administered. Care should be exercised that the procedures and regulations in each of these areas do not restrict movement.

### **Stabilization of Economic Activity in General Through Fiscal and Monetary Policy**

The serious disadvantages associated with policies designed to stabilize particular industries can be avoided by relying on the less specialized weapons of fiscal and monetary policy.

In contrast to policies that are focused on the particular industries that are in difficulty, fiscal and monetary policy are much more general in their effects, exerting their influence on all industries. This is not to say that each industry will be affected equally by a change in fiscal or monetary policy.

The danger of adversely affecting the rate of growth is not to be avoided, however, simply by a decision to use fiscal and monetary policy. Whether growth is adversely affected or not depends, not very surprisingly, on how fiscal and monetary policy are used.

Perhaps the main danger in using fiscal and monetary policy to reduce instability in output and employment is that another kind of instability—instability of the price level—will be increased, thus slowing up economic growth for reasons already mentioned. To show how the danger of price level instability is involved, we must first explain the circumstances in which the price level will be affected by fiscal and monetary policy.

**How fiscal and monetary policy can affect the price level**—Fiscal policy operates by changing the size of the government's deficit (or surplus) by altering revenues or expenditures or both. Thus if taxes are reduced, individuals and businesses are left with a larger income after tax than they had before, and a part of this additional income will be spent, thus tending to stimulate economic activity.

Monetary policy, administered by the Federal Reserve system, operates in the main by changing bank reserves, thereby affecting the willingness of banks to lend, and therefore the quantity of money (which is viewed as including bank deposits) and the rate of spending.

If fiscal or monetary policy is changed with the purpose of stimulating the economy, what happens to real output and prices depends on the level at which the economy is operating. If the spending of additional money can be matched by more real output, the result will be more output and little if any rise in the price level. That is, real output will expand with no great rise in the price level if there are unused resources of labor and productive capacity that can be brought into use. But if the additional goods demanded can be supplied only with increasing difficulty—perhaps higher wages have to be paid to induce people to enter or even to stay in the labor force—the demand for the limited supply of goods and services can be "satisfied" only by bidding up their prices. Only with higher prices will people stop trying to buy more goods and services than are being produced.

With this in mind, suppose unemployment rises because of a fall in the output of a particular industry that constitutes only a small part of the economy. If the rest of the economy is operating at a high level of output, it seems clear that an attempt to relieve this unemployment by application

of fiscal or monetary pressure (suppose that taxes are lowered or that bank reserves are increased) will probably result in a general price increase before unemployment in the industry concerned is reduced by a significant amount. Only a small part of the extra spending induced by the government's action will find its way to the industry that was the reason for the action.

If general fiscal-monetary pressure is applied to a succession of cases in which unemployment has appeared in an industry, the result will be a more or less continual upward pressure on the price level, a condition that makes it very difficult for businessmen—and consumers—to make the sound decisions needed for economic growth.

Premature application of fiscal and monetary pressure, resulting in a general price increase, is possible also in cases where unemployment is not concentrated on any one industry or area but is widely diffused over the economy. At any particular time there is clearly **some** output of the economy at which the application of fiscal-monetary pressure will raise the general level of prices. It is clear also that this output will be accompanied by some unemployment so long as there is adaptation to shifting demands, new ways of producing, investment, and necessary seasonal changes in the outputs of various industries.

If we are not prepared to tolerate a level of unemployment as large as this and insist that government exert fiscal-monetary pressure to reduce unemployment further, the result will be a general price rise that will continue so long as such a policy is followed.

**Is the highest tolerable level of unemployment inconsistent with price stability?**—It is conceivable that we are afflicted with a situation in which the burden on the families of those who are unemployed when level prices are maintained is too great, although the small amount of relevant evidence does not establish this view and can even be interpreted as supporting the opposite view. But the possibility of this conflict between price stability and the burden of unemployment must be kept in view. Before reaching even a tentative conclusion that the conflict is a real problem, two cautions are in order:

1. We should be sure that the burden of unemployment has been assessed as accurately as possible, granted that precision in this assessment is impossible. The significance of total unemployment of, say, two and one-half million workers is not self-evident nor is it always the same.

2. If we find that the lowest amount of unemployment consistent with level prices still involves what is felt to be too heavy a burden on particular families, it should be remembered that this burden can be relieved in ways that do not involve inflationary pressure. For example, it would be comparatively easy to adjust the present structure of



## JANUARY ATLANTA AREA ECONOMIC INDICATORS

ITEM	January 1956	December 1955	% Change	January 1955	% Change
<b>EMPLOYMENT</b>					
Job Insurance (Unemployment)					
Payments -----	\$198,746	\$207,032	-4.0	\$360,544	-44.9
Job Insurance Claimants† -----	3,526	3,092	+14.0	5,697	-38.1
Total Non-Agricultural Employment -----	325,600	333,200*	-2.3	304,650*	+6.9
Manufacturing Employment -----	90,400	90,750*	-0.4	81,300*	+11.2
Average Weekly Earnings,					
Factory Workers -----	\$68.06	\$71.28	-4.5	\$64.56	+5.4
Average Weekly Hours,					
Factory Workers -----	39.8	41.2	-3.4	40.1	-0.7
Number Help Wanted Ads -----	9,496	6,756	+40.6	8,090	+17.4
<b>CONSTRUCTION</b>					
Number of Building Permits,					
City of Atlanta -----	707	532	+32.9	700	+1.0
Value Building Permits,					
City of Atlanta -----	\$4,007,423	\$2,840,560	+41.1	\$11,610,951	-65.5
Employees in Contract Construction -----	19,200	19,550*	-1.8	16,500*	+16.4
<b>FINANCIAL</b>					
Bank Debits (Millions) -----	\$1,538.7	\$1,598.1	-3.7	\$1,330.2	+15.7
Total Deposits (Millions)					
(Last Wednesday) -----	\$1,052.3	\$1,094.3	-3.8	\$1,003.1	+4.9
<b>POSTALS</b>					
Postal Receipts -----	\$1,402,460	\$1,990,122	-29.5	\$1,362,782	+2.9
Poundage 2nd Class Mail -----	1,206,610	1,263,319	-4.5	1,317,041	-8.4
<b>OTHER</b>					
Department Store Sales Index					
(Adjusted) (1947-49=100) -----	149	154	-3.2	146*	+2.1
Retail Food Price Index					
(1947-49=100) -----	108.2	108.3	-0.1	110.2	-1.8
Number of Telephones in Service -----	275,189	271,185	+1.5	256,133	+7.4

\*Revised

†City of Atlanta only.

Sources: All data on employment, unemployment, hours, and earnings: Employment Security Agency, Georgia Department of Labor; Number Help Wanted Ads: Atlanta Newspapers, Inc.; Building permits data: Office of the Building Inspector, Atlanta, Georgia; Financial data: Board of Governors, Federal Reserve System; Postal data: Atlanta Post Office; Retail Food Price Index: U. S. Department of Labor; Department Store Sales and Stocks Indexes: Federal Reserve Bank of Atlanta and Board of Governors, Federal Reserve System; Telephones in Service: Southern Bell Telephone and Telegraph Company.





## JANUARY, 1955 AND 1956

1956	1955	ITEM	% CHANGE
9,496	8,090	Number Help Wanted Ads -----	+17.4
19,200	16,500	No. Construction Employees* -----	+16.4
\$1,538.7	\$1,330.2	Bank Debits (Millions) -----	+15.7
90,400	81,300	No. Manufacturing Employees* -----	+11.2
275,189	256,133	Telephones in Service** -----	+ 7.4
325,600	304,650	Total Non-Agricultural Employment* -----	+ 6.9
\$68.06	\$64.56	Average Weekly Earnings, Factory Workers* -----	+ 5.4
\$1,052.3	\$1,003.1	Total Deposits (Millions)** -----	+ 4.9
N.A.	N.A.	Department Store Stocks** -----	+ 4.0
N.A.	N.A.	Department Store Sales, Based on Dollar Amounts** -----	+ 3.0
\$1,402,460	\$1,362,782	Postal Receipts, Atlanta Post Office -----	+ 2.9
707	700	Number of Building Permits, City of Atlanta -----	+ 1.0
39.8	40.1	Average Weekly Hours, Factory Workers* -----	- 0.7
108.2	110.2	Retail Food Price Index (January) -----	- 1.8
1,206,610	1,317,041	Poundage 2nd Class Mail, Atlanta Post Office -----	- 8.4
3,526	5,697	Job Insurance Claimants -----	-38.1
\$4,007,423	\$11,610,951	Value Building Permits, City of Atlanta -----	-65.5

\*Average Month  
 \*\*End of Period  
 N.A.—Not Available  
 Sources: Same as page 4.

unemployment insurance benefits more closely to the "real" burden of unemployment if this were felt to be desirable.

An assertion that a certain number of unemployed is "too large" can be given meaning only by going behind the figure. There are two ways to approach the problem of deciding at what point the burden of unemployment becomes too large. One approach has been to ask how **much** unemployment is necessarily associated with the adjustments that accompany the long term shifts in demands and production methods that are always taking place in the economy. Presumably those who approach the problem in this way do so because they feel that the consequences of trying to reduce unemployment below this point would be even more serious. Any level of unemployment below this point would not be regarded as too large; rather, it would be regarded as too small.

The other approach is to assess the burden of unemployment directly. Even if it is decided to accept the volume of unemployment needed to permit adaptation to shifts in demand and methods of production, the **burden** of unemployment on families is not thereby rigidly determined. Both the assessment of this burden and policy toward it represent additional problems.

The following propositions suggest ways in which the burden of unemployment can vary independently of the number of workers who are counted as unemployed. The burden of unemployment is less for a single person with no dependents than for a married worker with dependents. Perhaps most people would regard the unemployment of 100 people for one week as preferable to the unemployment of ten people for ten weeks. Unemployment that does not reduce a family's income to zero because there is more than one wage earner is not as bad in its effects as unemployment that leaves a family without income. The burden on an unemployed worker is reduced by unemployment compensation, and so on.

Considerations of this sort counsel caution in dealing only with the statistic of total unemployment. If attention is paid only to total unemployment, there is a risk of instituting an inflationary policy for situations that really are not serious in terms of family burden. There may even be cases where an increase in unemployment does not mean an increase in family burden, for the make-up or composition of unemployment may have changed in such a way as to decrease family burden.

It is encouraging to note that considerations of this sort do receive official attention. For example, the Monthly Report on the Labor Force compiled by the Bureau of the Census contains data on those with jobs but not at work, hours of work,

duration of unemployment, and so on. And additional information is now being provided by the U. S. Bureau of Employment Security. A few months ago it began the collection of more detailed information on the status of unemployment insurance claimants. While these claimants are only somewhat more than half of the unemployed, these data permit a much better assessment of the significance of both the level and changes in the level of unemployment than has ever been possible before.

What influence, then, should the status of unemployment have on fiscal and monetary policy? To what point should unemployment be lowered through the use of fiscal and monetary policy?

If the level of unemployment that is believed to involve undue family burden is above the level of unemployment at which attempts further to increase output results in rising prices, one part of the problem is easy. In this case a judicious use of fiscal-monetary policy conceivably can bring unemployment down to a point where family burdens are not excessive without causing a general price rise.

Suppose, on the other hand, that the use of fiscal-monetary pressure to increase output and employment results in general price rise **before** unemployment has been reduced to a point where family burdens are tolerable. It may seem that there must be a choice between excessive family burden and price rise, but this would be the case only if application of expansionary pressure to reduce unemployment were the only way to reduce family burden. Family burden can be reduced independently of the level of unemployment, for example, by altering the level or structure of unemployment compensation and of other benefits. Furthermore, fiscal and monetary policy are not the only way to change unemployment. Measures to decrease the immobility of labor that may be an important reason for continuing unemployment have already been mentioned.

These considerations may be summed up as follows: if we think it is truly important to avoid general price rise (and the argument here has been strongly in support of this view), on the upward side we can afford to let stability of the price level be the guide to the application of fiscal-monetary policy. This does not necessitate any ignoring of the burdens imposed on families by unemployment. If the application of fiscal-monetary pressure to reduce the burden of unemployment to a tolerable level results in a general price rise, we should stop before this point is reached and proceed to reduce family burden in other ways. Thus a tolerable level of family burden and stable prices may well be consistent provided adequate use is made of the different means, of which unemploy-



ment compensation is the most important, for reducing family burden. And it may even be that there is in fact no substantial problem of consistency.

#### How should fiscal-monetary policy be used?

—The conclusion that it is possible to use fiscal-monetary policy to combat unemployment without continually raising the price level still leaves the more difficult problem of how fiscal-monetary policy should be used. How soon and in what amounts should measures be taken to combat increasing unemployment? This problem can be dealt with here only in a sketchy fashion.

We know what sorts of action will ordinarily have a stimulating or contractive effect. An increase in the government deficit will tend to expand the money volume of economic activity. An increase in the quantity of money will tend to lower interest rates and increase spending. But the level of economic activity at any particular time is not completely determined by the fiscal and monetary policies followed by the government and the Federal Reserve Board. The spending decisions of businessmen and consumers lead an independent life of their own, and our understanding of them is decidedly incomplete. This means that it is very difficult to predict in a systematic way the level of economic activity that will follow a given change in fiscal or monetary policy. This difficulty is enhanced, especially for fiscal policy, by the time it takes to recognize the need for a change of policy and to bring the new change into effect. It is clear that these delays are substantial for changes in both tax rates and expenditures.

It is possible, then, that we are faced with a dilemma. On the one hand, if we try to confine fluctuations to a narrow range by taking prompt and vigorous action, by the time the effects of the action unfold it may often happen that the change in policy was too great, with the result that fluctuation is actually increased. On the other hand, delay in instituting action to counter a decline or restraint in the amount of action taken may permit the decline in activity to cumulate to a point where it cannot be stopped before unemployment and output reach very unsatisfactory levels.

Understanding of our economic system is not yet at the point where we can be sure whether this dilemma confronts us or not. There are at least two outs. First, prompt but limited offsetting action may turn out to be sufficient to prevent the development of substantial price rise or the cumulation of a decline. Second, even though prompt but limited action at the beginning of a decline may sometimes permit a sizable decline to develop, it may be possible to put a floor to the decline by taking stronger measures later in the decline. We may

prefer a system with occasional declines to this level to a system that permits periodic jags of inflation or even larger fluctuations of output that may well accompany attempts to stabilize output within too narrow a range.

Although any positive statement on whether or not we are faced with the above dilemma would be unwarranted, two comments are worth making. In the past our economy has shown what must be regarded as a surprising amount of resiliency. When one considers the inappropriate policies that have been followed in many of the declines in economic activity—especially the failure to adopt an institutional framework under which the quantity of money could be prevented from falling—it is perhaps surprising that declines have not been larger than they were. The supply of money is now under much better control, and changes in the size and character of the Federal budget have provided an opportunity to utilize an automatic flexibility in Federal revenues and expenditures that was not available to nearly the same extent even in the 1930's.

It is considerations of the sort we have been discussing that have led the Committee for Economic Development to advocate the use of a stabilizing budget policy and a flexible monetary policy to prevent excessive instability.<sup>1</sup>

Under CED's version of a stabilizing budget policy, fluctuations in economic activity would be counteracted by an "automatic" change in the Federal government's surplus (or deficit). This would be accomplished by setting tax rates so that at a high level of employment (say 96% of the labor force) tax yields (meaning all receipts of the cash budget) would equal expenditures in the cash budget as they would be made at a high level of employment. If the percentage of the labor force employed fell below 96%, tax collections (not tax rates) would fall, leaving taxpayers with more money to spend. At the same time, some government expenditures would automatically increase, notably unemployment compensation payments. Thus a stimulating deficit would be created that would be reduced as economic activity climbed back to the target level.

On the other side, an increase in the money volume of output over the level corresponding to 96% employment would automatically produce a restraining surplus.

In this way there would be an early response of Federal revenues and expenditures to changes in the level of economic activity, but it would be a

1 CED's views on fiscal and monetary policy are discussed at length in the following policy statements: *Defense Against Recession: Policy for Greater Economic Stability* (March, 1954); *Flexible Monetary Policy: What It Is and How It Works* (March, 1953); and *Taxes and the Budget: A Program for Prosperity in a Free Economy* (November, 1947).

response that is adjusted to the amount by which the target levels of employment and economic output have been missed. This is a response that is already present, of course, provided that tax rates are not moved in a direction opposite to the change in economic activity. In the event of serious depression or inflationary pressure, the CED suggests that consideration of changes in tax rates and in some government expenditures (notably public works in the case of severe depression) would be appropriate.<sup>2</sup>

The other part of the stabilization policy espoused by the CED involves the flexible use of monetary policy. Without the proper use of monetary policy, a change in the Federal surplus or deficit will lose much of its effect. But beyond this, monetary policy has important functions to perform. The monetary authority can apply contractive or expansive force as soon as prices and/or the volume of employment give evidence of moving too far from desired levels. Equally important, the monetary authority can reverse its action promptly, something that can be done with fiscal policy—apart from the “automatic” changes in revenues and expenditures caused by changes in the flow of national income—only with a considerable delay. Congressional action on tax rates and expenditures will not be prompt or rapid except in special circumstances.

Maintenance of a long run increase in the quantity of money is perhaps as important to stability as the short run actions of the monetary authority. A steady increase in money is important not only for the maintenance of a stable price level over the long run. Prevention of a fall in the quantity of money when economic activity begins to contract is of first order importance in preventing minor contractions from cumulating to serious dimensions.

### Summary

We set out to explore some of the issues involved in the compatibility of economic growth and stability, asserting that the aspect of stability with which the people of this country are most

concerned is undue fluctuation in family incomes caused by unemployment.

Economic growth will inevitably produce some unemployment and instability of output. But not all instability comes from growth, and within limits instability can be reduced without reducing the rate of economic growth.

In attempting to reduce instability, care must be taken that the measures adopted do not adversely affect the conditions that are necessary for a high rate of growth. Included in these are the level of efficiency at which the economy operates, a feeling that there is opportunity for profit and monetary reward, and price level stability.

It was then argued that an attempt to reduce instability by “stabilizing” particular industries will adversely affect growth by creating rigidities in the economy. Premature use of the more general weapons of fiscal and monetary policy will also have an adverse effect on economic growth, either by causing successive increases in the general price level or by actually making output and employment more unstable.

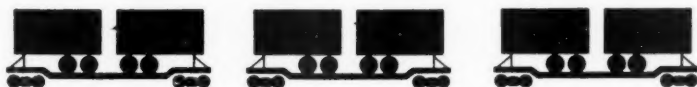
Fiscal and monetary policy should aim first at general price level stability. If the volume of unemployment associated with this requirement is regarded as too large, we should be sure that such a judgment rests on adequate knowledge of the burden of unemployment. Nor should it be forgotten that the burden of unemployment can be relieved in ways other than the use of expansionary pressure. But it may well be that a tolerable level of unemployment is attainable without running much risk of price inflation.

To attain the goals of price level stability and a high level of employment, the Committee for Economic Development has suggested (1) the flexible use of monetary policy and (2) a fiscal policy under which tax rates would be set to balance the cash budget at a high level of employment. If employment fell below this level, an expansionary deficit would promptly result because of the automatic decline in revenues and the increase in some expenditures. In the event of inflationary pressure, a contractive surplus would automatically develop.

We have regarded the main current policy problem in attaining both growth and stability as one of reducing instability to a tolerable level in such a way as to leave us with price level stability. A program that does not try for too much stability has a better chance of achieving these goals.

<sup>2</sup> Adherence to this fiscal policy would provide another advantage not directly related to stability. It would enforce the same type of discipline on expenditure decisions as would a fiscal policy requiring the budget to be balanced every year. Under a fiscal policy requiring annual balance of the budget, additional expenditure would require additional tax yields. Under the stabilizing budget policy, additional expenditure would require an increase in tax rates sufficient at high employment to provide revenue to cover the new expenditure. The stabilizing budget policy permits a corrective surplus or deficit to arise because the policy is directed to tax yields as they would be at high employment rather than to next year's actual tax yield as is the policy of balancing the budget every year.

Under the annually balanced budget, no corrective surplus or deficit can arise. If prices rise, taxes are reduced; if output falls, tax rates are increased. The changes in tax rates would tend to aggravate rather than counteract fluctuations in economic activity.



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